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## Economic transformations in Cuba: a review

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### ABSTRACT

After Raúl Castro's accession to the presidency of Cuba, the country has witnessed the most far-reaching process of economic reforms for more than five decades. The government has expanded the private and cooperative sectors, has passed a new foreign investment law, restructured most of its old debt and has sought to end the long-standing dispute with the USA. Yet economic performance has been poor and the country faces significant challenges and contradictions arising from the reforms. This paper analyses the macroeconomic environment and the changes introduced by the Cuban government over the period 2007–15. While successful at restoring macroeconomic equilibria, restrictive macroeconomic policies have hurt economic growth, whereas growth- and efficiency-enhancing measures are yet to produce results. Moreover, transformation of the economic model is slow because of its many internal contradictions. The paper also discusses some of the main impediments to future change.

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## Introduction: overall context of current changes in Cuba

Despite its small size, Cuba makes headlines in major academic journals and news media. Its unique 55-year background went through momentous times in 2015. During its first 30 years, the Cuban Revolution launched ambitious social goals, which received significant support from the USSR and the Council for Mutual Economic Assistance (Comecon). Over the past two decades, the majority of those considered to be the most important achievements of the Cuban society have been put to the test as a result of drastic change in external economic conditions. Until recently it was hard to discern either the existence of a clear strategy to maintain a generous 'welfare state' in the midst of an adverse situation or, above all, to overcome the economic crisis that has marked Cuba's development. Measures adopted in the 1990s were assumed to be temporary and, in general terms, did not incorporate the notion that the world had changed and, along with it, the aspirations and conceptions comprised within the concept of development.

For many, the Raúl Castro administration has marked a turning point in several ways. Immediately after taking over the country's presidency, he began to advance some ideas that have brought to fruition what can already be seen as a historic change in the Cuban socioeconomic model. The stated objective is to achieve an economic performance that is

good enough to make possible the great aspirations for welfare and social justice shared by most Cubans. However, the means to meet these objectives may clash with requirements for sustaining these same goals over the medium term, as has already happened with social equity. In addition, the world continues to change and countries are facing new constraints and opportunities.

In the late 1980s Cuba attained social achievements that were compared in many ways to those of some developed countries. Even after a very adverse period its rates of infant mortality, life expectancy and average years of schooling are among the best in the world. Likewise, outstanding results have been achieved in sport, arts and education for students with special needs, including access to a universal social security system and certain guarantees for low-income people. However, in other areas, such as housing, water-supply and sewage systems, public transportation, widespread access to Information Technology and Communications (ICT) and productive employment, progress has lagged far behind.

All this has been affected to some degree during the economic crisis of the past twenty years. Starting at least from the first decade of the 21st century, some setbacks have been recognised in the quality of health care and education;<sup>1</sup> results achieved in sporting events have also worsened. A remarkable deterioration of the housing stock has also taken place,<sup>2</sup> and a substantial income gap between different strata of the population has become more noticeable.<sup>3</sup> These processes are partially explained by the difficult economic conditions of recent years but at the same time many of the problems in the functioning of the socioeconomic system are not really new: since the mid-1980s clear signs of exhaustion of the growth model have become evident.<sup>4</sup> For five decades the economic foundations needed to sustain and improve these same indicators have been far less impressive. Per capita income is lower than in many Latin American countries with worse social indicators.<sup>5</sup> Additionally, the government saw dependence on imported food as a big threat to the nation's stability in the medium term. This explains why reforms started in agriculture even before the *Lineamientos* were adopted.

These concerns certainly triggered some alarm in the highest levels of government, with warnings that the country was taking an unsustainable path that would bring about damaging consequences for its economic, political and social model. Ever since Raúl announced the need for 'structural changes', it can be said that the government's actions are targeting two different fields: the correction of macroeconomic imbalances and the programme set out in the Guidelines pointing towards a new economic model.

This article reviews fundamental aspects of the current transformations, emphasising their main limitations and challenges. It is divided into four main sections. Following this introduction, the next section overviews the macroeconomic record of the *Raulista* period. The third section examines changes introduced in key aspects of the economic model, while in the fourth section these changes are critically discussed in light of the challenges of Cuban economic development.

## Macroeconomic overview: correcting imbalances

Raúl Castro's administration has faced a complex macroeconomic situation almost from the very beginning. The economy faced a financial crisis between 2009 and 2010 and, on the other hand, minimum conditions had to be ensured to begin the gradual transformation of the country's economic model. A review of some general indicators helps to understand the scenario policy makers have been faced with since 2008 (Table 1).

**Table 1.** Selected macroeconomic indicators, Cuba (2007–15).

	2007	2008	2009	2010	2011	2012	2013	2014	2015
Real GDP (annual growth rate)	7.3	4.1	1.4	2.4	2.7	3.0	2.7	1.0	4.0
Inflation <sup>a</sup> (percentage increase on a year earlier)	2.8	-0.1	-0.1	1.6	3.6	2.0	0.6	2.1	-
Unemployment rate (%)	1.8	1.6	1.7	2.5	3.2	4.6	3.3	2.7	2.4
Fixed gross capital formation	-3.5	51.3	-6.3	-3.0	4.9	6.0	6.3	-2.7	-
Gross capital formation (percentage of GDP)	10.2	14.8	12.7	12.3	13	13.6	13.7	12.9	-
Exports of goods and services (percentage increase on a year earlier, current prices)	20.8	4.9	-13.3	34.0	19.3	7.7	-0.4	-4.2	-
Imports of goods and services (percentage increase on a year earlier, current prices)	6.0	43.3	-35.2	18.8	32.3	-1.3	4.8	-11.1	-
Trade balance (millions of dollars)	1,585	-2300	1,245	3119	2240	3771	2991	3947	-
Budget balance (percentage of GDP)	-3.2	-6.9	-4.9	-3.6	-1.7	-3.7	-1.3	-2.3	-5.7

Source: Author's estimates, based on ONEI, *Anuario Estadístico de Cuba*, various years.

<sup>a</sup>Only includes CUP denominated prices.

The first aspect highlighted in the table is that, starting from 2008, the GDP growth rate declined substantially. This was a result of the combination of three adverse events. The first concerns the slowdown that had started in 2007 because of reduced rates of increase in sales of professional services rendered to Venezuela, a key source of growth in the 2004–07 period.<sup>6</sup> The fundamental reason for this lies in the saturation of that market, where import levels of Cuban services were very high and demand could not keep growing at the same rates attained in initial years. Although this result could have been expected, the development of new markets with a similar volume was unlikely, given the specific conditions of the Venezuelan market.

The second factor is related to the impact of the global crisis on the Cuban economy. Economic problems spread to most world countries, severely affecting the prices of some of Cuba's most important product, such as nickel and the flow of visitors in the case of tourism. With regard to nickel, it should be noted that its price dropped from a maximum of just over US\$50,000 per ton in April 2007 to \$9,600 in December 2009, a fall of 80% of its value in just eight months. These changes were immediately reflected in export earnings. This was the main export product within external sales, and the third most important one following professional services and tourism. In the case of tourism, problems in Europe and Canada – the main markets for Cuba – led to a reduction in gross revenues, compared to 2008. A decrease in sales of professional services was added in 2009, probably thanks to economic difficulties among our main trading partners, especially Venezuela, highly dependent on oil prices.

All this brought about a difficult situation in the evolution of Cuba's external trade balance, aggravated after late 2008 because of the need for extraordinary imports to meet the problems arising from the effects of three powerful hurricanes that hit Cuba that year. An additional element was the high price of food products, fuel and other key imports, which resulted in a significant expenditure increase, especially during the first half of that year.

This unfavourable trend was directly reflected in an increase in Cuba's debt and therefore in the volume of resources required to honour commitments to suppliers and creditors. However, the balance of payments strain did not begin in 2008; it had been developing beforehand, linked to major investments related to the energy and transport sectors. Because of the crisis, the ability to meet these commitments was significantly compromised, leading to a partial suspension of payments, which was most critical in 2009 and 2010. According

to estimates by some authors, restrictions in accessing foreign financing meant an impairment equivalent to 4% of GDP, while the reduced volume of exports additionally affected growth by 2.9%.<sup>7</sup> Only the terms of trade in 2009 slightly mitigated (0.5%) the negative impact on GDP.

In order to address this situation, the government implemented an adjustment programme aimed at restoring the servicing of its international obligations. The greatest impact was on imports, which fell by over one-third in 2009, and whose performance has depended ever since on the availability of external financing. The sharp decline of exports affected quite a few production lines – a typical feature in an economy extremely dependent on external purchases to complete the manufacturing cycle, and whose importing coefficient has been growing over the past decade, associated with the decay of the national industrial base. Although they were probably necessary, these drastic import cuts have significantly curtailed economic performance in recent years.

One difference from previous similar processes is that this time restructuring was directed towards trying to reduce the burden of foreign debt and to improving the country's bad reputation. In recent years external debt has been substantially reduced thanks to bilateral long-term debt renegotiations with major creditors such as Japan, Russia, Mexico and China. In all cases the cancellation of at least 70% of the debts, and the rescheduling of payments on acceptable terms, have been obtained. In December 2015 Cuba reached an agreement with the ad hoc group at the Paris Club, to restructure the outstanding debt totalling \$11.1 million, of which 76% is forgiven and the remainder is to be paid in 18 years with a favourable interest rate. The country still owes almost \$6480 million dollars to the London.

Investments have once again become an adjustment variable for tackling the country's imbalances. Table 1 shows that investment declined significantly in 2009 and 2010, then slightly recovered from that year on. The reduction in export volumes has an immediate recessive effect on the economy and undermines economic growth over the longer term; therefore new production capacities are not built and infrastructure is neither expanded nor modernised. It must be added that this situation only served to reinforce a trend that had already existed for two previous decades.

Because of the deterioration of the fiscal balance in 2008, the authorities adopted a restrictive policy in the management of state budget expenditures. Total outlays decreased in 2009 and 2010, thereby rendering the fiscal deficit manageable at a time when revenues remained under pressure. Given the fact that in Cuba there was no public debt market, 100% of the deficit in state accounts is monetised, which has a direct impact on price stability. Therefore this variable is closely monitored by the Central Bank. Any imbalance in this indicator must be corrected without delay in order to maintain low inflation rates and sustain the exchange rate at the official currency exchange houses (CADECA), another sensitive variable when it comes to public consumption.

Inflation in markets operating in Cuban pesos has been kept under control, which, within a scenario of stagnation in nominal wages, has contributed to limiting the negative impact on real wages.<sup>8</sup> However, performance in specific markets can vary significantly in comparison to the average. For example, in 2011 only, prices in the agricultural market segment soared by almost 20%, with an adverse impact on the population. In order to understand the priorities and the room for manoeuvre of decision makers, it is particularly interesting to discuss the essential characteristics and implications of the current monetary arrangement, which is based on the circulation of two currencies and the use of multiple exchange

rates. The system was originally conceived in the early 1990s as part of a broader set of anti-crisis measures. The main objective at the time was to isolate the emerging sectors of the economy (tourism, foreign investment) from the risk of devaluation associated with pressures on the official currency – the Cuban peso (CUP) – generated by the huge macro-economic imbalances accumulated between 1990 and 1994. This would provide the necessary guarantees to investors, ensuring the value of the currency in which they operated and the repatriation of dividends. It also stemmed from the government's initial step of legalising dollars in an effort to stimulate remittances as a source of hard currency.

In addition, it complemented other measures, such as the elimination of certain gratuities, the increase in prices of non-essential products and the introduction of certain taxes, all of them aimed at controlling fiscal deficit (which at peak reached 40% of GDP), controlling inflation and restoring the value of the peso. These initial objectives were essentially achieved after a short time.

Nevertheless, the fact that this mechanism has been in place for 20 years has generated other problems, which are as serious as, or even more serious than, those it was intended to solve at the outset. First, with the passing of time many different markets operating simultaneously have been established. Some differ when it comes to price formation mechanisms (regulated, fixed, free formation); others use various monetary signs (CUP, Cuban Convertible Peso [CUC], US\$). As a result, informal markets arise, very often operating through the arbitrage of price differentials. More serious still is the fact that measures of economic aggregates and of price formation, including relative prices, are presented in a distorted way thanks to the absence of a unified pricing system that reflects the relative scarcity of factors, inputs and consumer goods. This leads to inefficient decisions by all economic agents – producers, consumers and even the government itself, which lacks the undistorted information needed for planning the economy.

The most dangerous aspects are the dynamic effects of these distortions. For example, differences in the pay structure of certain occupations may be inducing a shift in the skilled labour force towards positions that do not necessarily require a high professional level. This may represent a personal gain for the individual in the short-term but it is a waste of resources at the societal level, because education is paid for by the state. Unfortunately, once a certain amount of time has elapsed under these conditions, it is very costly to reverse the situation, as lack of use of certain skills and knowledge may result in their atrophy. Similar processes may be occurring in other markets, while the huge current distortions remain.

A balance sheet of recent macroeconomic management shows some important achievements. In the midst of difficult conditions, it has been possible to restore a certain order in external finance. The financial position has even improved and credit – though in limited quantities – continues to flow into the country. Import controls made it possible to achieve surpluses for several years of this period, although these were made at the cost of reducing growth. Headline inflation and the exchange rate remained stable. A decrease and subsequent stabilisation of the fiscal deficit was also reached, with a reduced government influence on the economy<sup>9</sup>. However, if analysed as a whole, this package has significant recessionary effects: reductions in imports and investments, contraction of fiscal spending, restraint in public sector wages, among others. Despite the stability gains, much less progress can be seen in the implementation of stimulus measures and, above all, in the consistency and depth of those measures that have materialised. In the absence of this second component, macroeconomic stabilisation dies off quickly. Neither can public spending be permanently

reduced nor imports indefinitely contracted without this having a recessionary effect on the economy, which brings about unmanageable economic and political costs, even for the Cuban government. The following section addresses key elements of Raul Castro's programme of long-term changes and the extent to which they contribute to the achievement of sustainable macroeconomic adjustment, while creating new sources of sustainable growth.

## Emergence of a new economic model? Changes in key areas

### Ownership structure

The 50-year background of the Cuban economic model has been characterised by extreme caution when it comes to the involvement of the private sector in its productive activity, especially in the national capital. One of the distinctive features of the institutional process in Cuba was the rapid transformation of the ownership structure inherited from the previous period. As a result of the deep economic crisis in the early 1990s, the need to open the economy, increase efficiency and enable new forms of ownership in the economy was placed on the agenda. This paved the way for the first major readjustment in the ownership system, which required an explicit mandate from the Communist Party Congress and a constitutional amendment by the National Assembly. The most controversial issue has not been the attraction of foreign investment,<sup>10</sup> but rather the expansion of self-employment.

Reforms in the structure of land ownership that started in 2007, the subsequent easing of conditions for the operation of self-employment in September 2010, and authorisation granted for the creation of non-agricultural cooperatives, have all enabled the non-state sector to return to a size not seen since the mid-1960s. Currently it accounts for 28% of the workforce, an unprecedented figure in 50 years (Table 2). Employees of joint ventures with foreign capital, in representation offices and in wholly foreign-owned enterprises –which are included within the amount belonging to the state sector – should be added to this figure.

These figures show that the growth of the non-state sector is being led by the increase in the number of private jobs, where both self-employed workers and farmers are growing significantly. In the case of cooperatives, new jobs outside the agricultural sector are being reported, which still account for a small number of total employment. The process of creating non-agricultural cooperatives is cumbersome and slow. It demands the explicit approval of the Council of Ministers when it comes to newly created entities. A significant proportion

**Table 2.** Employment by forms of ownership, Cuba (thousands of employees).

	2007	2014
Total employment	4867.7	4969.8
Public	4036.1 (83%)	3591.3 (72%)
Private	589.5 (12%)	1147 (23%)
Farmers	451.1	663.6
Self-employed (cuentapropistas)	138.4	483.4
Cooperatives	242.1 (5%)	231.5 (5%)
Cooperatives (agriculture)	242.1	226
Cooperatives (all other sectors)	-	5.5

Note: Percentage of total employment shown in brackets.

Source: ONEI, *Anuario Estadístico de Cuba*, various years.

of the new cooperatives have emerged from former state enterprises that have been converted to this new form of management, which has generated some problems related to their functioning and profitability.<sup>11</sup> To this we must add that the legal framework is still a challenge because non-agricultural cooperatives are regulated through a decree-law that considers them an experiment. In addition, the one that is currently in place contains weaknesses and contradictions that limit the scope for cooperatives.<sup>12</sup>

Despite all this, there are distinctive features within the current process that make it qualitatively superior to earlier transformations in the 1990s, which occurred on an *ad hoc* basis, and were subsequently partially reversed. Current changes are taking place within a broader context of reforms in the economic model, which also promotes greater participation of foreign companies, and management changes within the state company itself.<sup>13</sup> The possibility of a real correlation with the public sector is also being raised through contracts for service delivery and production. Additionally, the possibility has opened to access the financial system, both using certain services and obtaining credits, which in turn poses several challenges.<sup>14</sup>

### **Resource allocation mechanism**

The other element that is part and parcel of the essence of the Cuban model is the resource allocation mechanism. The Annual Plan of the National Economy, the state budget, the Central Hard-currency Fund and the dual monetary and exchange system<sup>15</sup> themselves are among the institutions that perform this function. In these institutions foreign exchange and inputs are centrally administered and allocated, and capital accumulation is managed. This has been the institutional response to a context characterised by productive and social needs that exceed Cuba's capacity to guarantee that these needs are met. Its current form presupposes that compatibility between ends and means is achieved in the short term and that this annual sequence automatically guarantees an efficient dynamics in the use of resources.

Practical results, nonetheless, show mixed results. When it comes to running this mechanism, advanced information requirements are to be met by the central planner, together with major processing and coordination costs, and incentives generated do not encourage this type of information to be provided to planners. The absence of a functional price system means that even agents themselves do not have accurate information about their own environment. In addition, the vulnerability of the accounting system, monetary distortions and the size of the informal economy suggest that information which is conveyed at all times to the central planner is not enough, and also does not reflect the actual conditions in which the economy operates. Since central planning generally deals with imbalances in administratively, distortions are repressed or hidden, very often surfacing in a particular way. For instance, queues and/or scarcity, rather than rising prices, reflect the fact that demand is higher than supply. However, the system lacks a quantitative assessment of the problem, making it harder to address it, which exacerbates these distortions. Unfortunately the diagnosis that has prevailed attributes these failures only to lack of demand and to indiscipline in complying with the relevant provisions.

Although this central allocation mechanism is the one that prevails in Cuba, there is room for decentralised allocation of certain resources, even though these are much less important in terms of economic impact. This could include the huge informal economy, which is

sustained not only by resources diverted from the public sector itself but also by sources outside the country. It is common knowledge that a significant share of the financing of many new private businesses comes from relatives and friends living in other countries, and it is well documented that individuals import significant quantities of consumer goods, and increasingly, inputs and capital goods for these business ventures.

### ***New sources of accumulation***

Generally, in small developing countries, access to foreign savings is key to ensuring adequate investment levels in economic and social development, given the lack of domestic resources. Cuba is no exception. Since the generous external compensation provided by the links with Comecon disappeared, investment levels have remained very depressed. Although internal resources are limited, in order to make better use of domestic savings a much different financial system from the one in place is required. The new credit policy adopted in 2011 improved the chances of obtaining loans in Cuban pesos from commercial banks for certain purposes, including the financing of new private businesses. However, lengthy procedures and amounts granted are not attractive to potential borrowers. For non-state productive activity only the equivalent of \$65.6 million dollars had been granted in loans between 2011 and July 2015.

Given current conditions, it is reasonable to assume that foreign savings will be needed in order to significantly increase current levels of accumulation. Overall this source will be required to make an even higher contribution than national sources. But a range of constraining factors has kept the perception of financial risk associated with Cuba very high over the past two decades. These include a poor credit rating, based on the unilateral suspension of payments in 1986 to the Paris Club creditors, among other events. There is also the fact that Cuba is not a member of any multilateral financial institution.<sup>16</sup> Sovereign risk rating agencies incorporate these factors into their assessments. In Cuba's case, out of the three best-known agencies (Standard and Poor's, Fitch and Moody's) it was only the latter that began to assess the financial position of the Cuban government from 1999 on. The rating initially issued (Caa1) – downgraded in April 2014 to Caa2 – is included within the 'junk debt' grade, which implies that any exposure to the debtor should be considered high-risk.<sup>17</sup> Moody's recently changed its outlook for Cuba from stable to positive, citing less exposure to Venezuela, warming relations with the USA and momentum in the reform process.

The steps discussed in the previous sections are positive in the sense of improving Cuba's financial position, but it is understood that the nation must use other channels more actively, such as foreign investment.

Even though Cuba passed a foreign investment law in 1995, the role played by foreign direct investment (FDI) has been well below actual needs and what other countries have achieved over the same period.<sup>18</sup> The transformation programme projected a change of vision with regard to the role of foreign investment. By the end of 2013 the Mariel Special Development Zone initiative was launched, and a new law was passed in March 2014 (Law 118). The Cuban Minister of Foreign Trade and Foreign Investment has toured several countries promoting the new regulations, and the Center for the Promotion of Foreign Trade (ProCuba) was entrusted with the task of coordinating actions to promote Cuba as a destination. Among the new features contained in this initiative are generous tax exemptions,

modifications in the role of the state employment agency that mediates labour force recruitment and the preparation of the so-called Investment Opportunities Portfolio, which highlights projects prioritised by the government. The scope of the new policy could be widened if the rapprochement with the USA continues, since it has aroused a great deal of interest among investors there and in other countries. Nevertheless, although attempts have been made to simplify the complex process for the review and approval of proposals, the fact is that they still fall a long way short of the best international practices in this field. Two years after launching the Mariel project, only six foreign enterprises have been approved to operate in the Zone.

Another current funding source whose relative importance has increased over the past two decades is remittances. As compared with current exports at the end of 2014, remittances generate slightly over 10%,<sup>19</sup> which is no small thing, considering that it is a flow without compensation (to which should be added transfers in kind).<sup>20</sup> There is a need to consider the design of schemes to use remittances for productive purposes and thus to enhance their impact on the economic fabric. It is generally accepted that foreign money is used as seed capital for new businesses. The government should create incentives so that such flows go through to Cuba's financial system; eventually part of those resources could be utilised to build new houses or carry out maintenance of existing units. This is already taking place informally anyway.<sup>21</sup> Given the growing importance of these flows to developing countries, particularly in Latin America, authorities in several countries have developed initiatives to redirect remittance flows towards productive sectors, including programmes to boost investment in real estate projects, savings accounts and the promotion of small and medium-size enterprises.<sup>22</sup> Current economic changes and the gradual lifting of restrictions on transactions between the USA and Cuba suggest that this flow will continue to grow in the future. So it makes sense to design policies to maximise the economic impact of remittances in the Cuban economy.

### **A look at the past nine years (2007–15)**

On the threshold of a new Congress of the Cuban Communist Party, the seventh since the triumph of the Revolution and the second after Raúl became president, it is worth making an assessment of the achievements and failures and, above all, how they have influence the country's situation looking into the future. At the time of writing, the end of 2015, Cuba is in many ways very different compared to a decade ago.

In relation to global economic performance, average annual GDP growth stands at 3.2%, a figure that is lower than that achieved in the 1994–14 period and is also below the figure achieved between 1994 and 2006. However, it is not significantly different from Cuba's performance since 1902, or from what was achieved during the early revolutionary period (1959–89). Ironically Cuba barely got any direct benefit from the commodities boom in the previous decade,<sup>23</sup> with the probable exception of nickel exports. The country had already become essentially an exporter of services,<sup>24</sup> while it suffered starkly in the following slow-down period. The truth is that at this rate it would take Cuba nearly 19 years to reach the level of GDP per capita that Chile had in 2014, and a little more than 47 years to reach the level of Singapore that same year. In short, judged against the need to close the gap with regard to more demanding standards, much remains to be done.

Nevertheless, there are some elements within this context that are worth highlighting, in contrast to stages. During this period the biggest reform of the Cuban economic model in 50 years has already been launched with perfect clarity, a reform that has moved beyond the pure economic realm to include a gradual but determined approach to the USA and modifications to the political system. Second, it has been clearly understood that normalisation of the external financial situation involves honouring the commitments entered into and accepting the basic rules that govern international finance. And that is no small development. It could also be said that this was beginning to occur when the worst global economic crisis in decades was unleashed, from which the world has still not fully recovered.

As a result of this transformation process, it can be said that certain conditions for better performance in the future are being created; these include certain aspects of the management of macroeconomic balance and others with a structural nature. Doing away with the policy of previous years, in the plan conceived for 2015, import control is reduced as the main way out for generating the necessary external surpluses. This should inject more dynamism into the economy and relieve shortages of consumer goods in the domestic market.

In addition, experiments with a public debt market have started to finance up to 70% of the budget deficit, so far only with the participation of national state-owned entities, especially the banks. This is a necessary step to ease the government's budget constraints and to be able to use expenditure growth to boost demand. It also allows for a decoupling of the deficit from the movement of prices, while the monetary issue is reduced in order to finance the public sector. These two components could help the authorities successfully complete monetary and exchange rate unification.

In late 2013 the beginning of the long-awaited transition to a monetary and exchange system – better tailored to the needs of a modern economy – was announced. In this sense the possibility for most retail companies of making transactions in both currencies is becoming widely available, while it has been announced that the state sector is receiving instructions and is being prepared for the transition to the new scheme. Nonetheless, it should be noted that, even considering the risks and the required gradualness of these steps, the process has not developed at the speed anticipated by many. It has raised high expectations among the public and also among economic actors. In the light of other experiences, uncertainty is not usually an ally of these types of situations. As a result of the extension of this stage, there has been an evident restructuring of savings away from the weak currencies. This is forcing a new dollarisation of operations in certain circuits, strengthening the informal exchange rate market, and possibly casting more doubt on the government's ability to lead the programme to fruition.

Although it was announced in late 2014 that international reserves had reached \$10 billion – a good anchorage for the Central Bank – in some ways the current situation is even more confusing than that of a few years ago. This is because of the introduction of several partial exchange schemes, such as the one used by hotels that receive agricultural products directly supplied by producers (10 pesos to 1 convertible peso).

In the background there are other contradictions that have emerged as the old economic model fades. It is especially useful to consider them in the light of the problems faced by Cuba's economic development, which carries long-standing gaps. There is almost unanimous consensus among experts in Cuba about the need dramatically to increase capital formation in order to halt the erosion of the productive base and to provide the nation with the required physical infrastructure, if further progress is to be made in the 21st century, as well as about the need to meet challenges such as the aging of the Cuban population. However, in the



Guidelines themselves it is stated that accumulation of capital in the non-state sector will not be allowed – which is then embodied in regulations as the tax code – an objective that has been reiterated by several leaders of the nation.

In other words, it seems that the only role to be played by this emerging sector is to become the ultimate recipient of the surplus labour force in the public sector, now that it has been accepted that inflated payrolls are not the most sustainable way to create well-paid jobs. At some point it was even suggested that self-employed workers and cooperatives could absorb up to 40% of total employees (they have almost absorbed 30% with little support), a fraction that should not be disregarded. This logic suggests the operation of a dual economy, with a second-class segment, not granted the many facilities to grow and become more sophisticated that it requires.

This is in contrast to the huge tax exemptions that have been granted to foreign investors, in and out of the Mariel Special Zone Development. In addition, foreign investors can participate in almost all economic sectors, although contradictions are also present here. A study conducted in 2012 clearly indicated that the old tax regime was a neutral element in the assessment of Cuba as an investment location.<sup>25</sup> However, in other areas identified as negative (labour system, legal framework, domestic distribution channels, financial system and authorisation procedures) less progress is being made under the new rules. This suggests an unbalanced incentive scheme with a large fiscal cost, which would not have the desired effect on potential investors. Clearly, the consensus required to advance the most sensitive issues has not been achieved.

Nevertheless, the current legal framework considers foreign private capital to be more profitable for the country than Cuban entrepreneurs – a vision that is not only discriminatory but also short-sighted and dangerous. Cubans who put their own resources – limited in many cases – at risk to open a small business have a huge economic value to the country. They have chosen to pursue a life project in their own country, to create jobs directly in their communities, to produce goods and services that are not offered by the public sector, to apply knowledge acquired in the Cuban educational system (acclaimed by all), to begin paying taxes almost from day one, and most of them aspire to make a living from their own work. It is not a question of having no alternative such as, for example, going to live in another country, since that option is now much easier. It is difficult to understand why any government would not stimulate such an initiative, even more so when the contemporary left has a distinctly anti-corporate, nationalist and locally oriented agenda.

Worst of all, despite all the proclamations and regulations, accumulation is taking place anyway under a system of perverse incentives that sometimes stimulates the emergence and appropriation of spurious rents. For instance, too many Cubans engage in street trade of merchandise acquired in the domestic retail system, but this does not create new products. Since productive activities are restricted, and growth and accumulation are seen as a threat, talented and well-connected people devote their energy to these activities.

This is very common when the playing field is not level and artificial entry barriers are erected by delaying or denying permits to access the market, both in the private and cooperative sector. The same is true when an efficient and successful business runs into too many restrictions to continue growing. As a result of these difficulties people feel compelled to break the law, making legitimate regulation more difficult, if not impossible, and preventing an efficient allocation of resources in the economy. Thus more productive enterprises fail to attract more labour and capital.

This is directly related to the inconsistencies between changes in ownership structure and the resource allocation mechanism, designed to control all factor and input flows in an economy with a large majority of state-ownership. This decoupling has become more evident in recent years because of the emergence of self-employed workers and cooperatives and the strengthening of allocation mechanisms dependent on the government. Both the central plan and the allocation of foreign currencies and foreign trade function more strictly now than in the 1990s. This creates two major problems. On the one hand, the non-state sector loses some of its meaning, while formal ownership is not fully exercised from the economic point of view. If a business owner wants to exercise the right of expanding production by purchasing more equipment, most likely he/she will be unable to do it or will have to buy such equipment in the informal market. This applies, for example, to farmers. There is no formal market for agricultural machinery such as tractors and irrigation equipment. The same is true with respect to capital. The backwardness of the Cuban financial system has stimulated the informal financing – often from external sources – of a large majority of the new enterprises, which is posing several challenges.<sup>26</sup>

Additionally, the first signs of a detachment can also be seen between job assignment and other productive factors in the economy. Jobs are considered the most mobile production factor for a number of reasons. In the previous model their assignment could be channelled according to the preferences of planners, while labour supply depended on the education system – directed by the authorities – and demand was set in advance according to major investment plans. These often involved physical displacement within the country, which was accompanied by the construction of new communities. Currently, labour supply in terms of skills structure is still largely determined by the public education system, but other alternatives are emerging, and it is widely accepted that it should be reformed to meet the demands of a different economy. In addition, the international mobility of the Cuban labour force has increased substantially over the past decade, especially since 2013, when new immigration measures were put in place. Within the country itself there are many more employment alternatives outside the state sector than a few years ago. According to the above explanation regarding the allocation mechanism of other factors, in this new scenario it may frequently happen that the movement of the workforce to other activities does not generate a proportional flow of capital and inputs in the same direction, which ends up favouring an inefficient use of this factor.

This inflexibility translates into lower productivity and even deskilling. There could be at least two different causes. The first assumes that the split occurs because regulations prevent creation of a job that requires the same qualification as for the job that is being displaced. An example of this is when an engineer gets a job as a waiter or restaurant manager. Since there is no possibility of creating a private company specialising in engineering services, the rejection of the previous position is solved by taking another job that provides better income, but it is actually a waste of the skills acquired by this employee. But there is a cause that is even worse: when the new job is compatible with the qualifications of the worker or, otherwise, when current restrictions prevent this worker from becoming more productive over time. The reasons have been discussed above: the company cannot grow enough, cannot buy more modern equipment, cannot expand beyond the domestic market, and does not have a sophisticated financial system and other specialised services, among others.

Cuba needs to build a prosperous economy, one that can serve both its people and its bold social goals. On that path it faces significant challenges that should not be

underestimated. However, it is not too late to tap into its vast, and largely unproductive, pool of educated Cubans. This will require leaving behind many dogmas, embracing the global economy and, above all, empowering its own people from within. In this regard it is becoming increasingly clear that the reforms over the past eight years, though a most welcome development, are just the early stage of a very long journey.

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No potential conflict of interest was reported by the author.

## Notes on Contributor

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## Notes

1. González, "The Sharp Edge."
2. By the late 1980s a housing deficit of around half a million units had been calculated. Rodríguez, *La estrategia de desarrollo*.
3. Ferriol, "Política social y desarrollo"; and Espina, "La política social en Cuba," 135–136.
4. Triana, 1999; and Figueiras, *Aspectos estructurales*.
5. Torres, "Transformations."
6. It should be noted that GDP measurements changed from 2003 on, essentially giving greater weight to social services. The growth in exports of these services was therefore well represented in the GDP series, contributing to the attainment of high growth rates.
7. Mesa-Lago and Vidal, "The Impact of the Global Crisis."
8. It is worth recalling that at the end of 2014 the real wage was equivalent to 35% of the 1988 level (author's calculations). However, it must also be recalled that wages were the main source (and often the only source) of income for the vast majority of families in 1989. At present this has changed significantly. This complicates measurement of the purchasing power of Cuban consumers.
9. The degree of quasi-taxation is high in Cuba, which hides the government's true fiscal position. Hidalgo and Barceló, "Cuasifiscalidad."
10. In March 2014 Cuba's National Assembly passed – in a special session – Law 118 on Foreign Investment, which includes all areas within the potential destinations for foreign investors, except education, public health and defence. However, the national private sector is limited to a short list of activities, mostly simple services and light manufacturing. Nevertheless, theoretically cooperatives can participate in all areas, although, in practice, up to 2015 the sectoral profile has been very similar to that of self-employment. This topic is more thoroughly discussed in other sections of this paper.
11. Piñero, "Nuevas cooperativas cubanas."
12. Mesa, "Cooperativas no agropecuarias."

13. An important difference, in addition to long-term transformation goals, has to do with the role granted to cooperatives, as a form of ownership that is more collective than private, although in principle it is useful to address many of the weaknesses of the traditional state company.
14. León and Pajón, "Política crediticia en Cuba."
15. This type of scheme is ultimately a response to a major problem associated with the chronic shortage in the supply of hard currency, which in turn is derived from an imbalance in the balance of payments. The scheme allows one to assign currencies centrally for a period, depending on the 'systemic' importance of the applicant, for example, import of food, energy, commodities, etc. These arrangements have been tested in other contexts in the past. Even in 2014 there were two other countries in Latin America (Argentina and Venezuela) using dual currency and exchange controls. Empirical evidence suggests that these are very expensive and inefficient methods and should be disregarded as soon as possible. De la Torre and Ize 2013. The difficulty in the Cuban case lies in the fact that the use of these controls has been delayed considerably over time and it is part of a wider set of central mechanisms for allocating resources. This implies that the economy has been subject to deep distortions for an extended period, with disastrous effects not only in static but also dynamic terms (behaviours, preferences, informality).
16. An assessment of the importance of the return of Cuba to institutions like the World Bank and the IMF, and some mechanisms to make this possible in the medium term, are found in Feinberg 2011.
17. On 10 December 2015 Moody's reaffirmed the Caa2 rating, but changed its outlook from stable to positive, citing lessened dependence on Venezuela, and continued reform and rapprochement with the USA. More importantly the new outlook opens the door to an upgrade over the coming months.
18. Pérez, "Foreign Direct Investment."
19. This calculation is based on the recommendations in Guilarte 2014, taking into account several sources that estimate transfers to Cuba, which vary significantly according to the methodology used.
20. A more detailed discussion of estimates of remittances and their role in Cuba's economy can be found at Spadoni, "El descongelamiento."
21. Morales, "Balance del Trabajo."
22. Barceló, "Institucionalización del mercado."
23. Profits came indirectly through its trade partners, especially Venezuela.
24. Although this is more a result of the exceptionally poor performance of goods-producing sectors, especially agriculture, including the sugar industry and other simple manufactures.
25. CEEC, *La inversión extranjera*.
26. Vidal, "La apertura."

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